Sustainable Finance
The rise of green loans and sustainability linked lending
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Executive summary

Green and sustainability linked loans are a hot topic in the loan markets. They are a relatively recent innovation, but volumes have risen dramatically over the past few years to over US$99bn in 2018. The rise of green and sustainability linked loans signals the early stages of a fundamental shift in the wider economy.

At first, there were no recognised market standards to help determine what qualifies as a green or sustainability linked loan. While the Green Bond Principles first published by the International Capital Markets Association in January 2014 were a useful indication of the direction being taken in the capital markets, they focussed on bonds rather than loans, and on green use of proceeds rather than sustainability. In the loan markets, the Equator Principles have long been used by financial institutions for managing environmental, social and governance risks in the project finance market, but their application was limited in the wider loan markets.

Without the benefit of recognised market standards there was a risk of diverging approaches being taken on what amounts to a green or sustainability linked loan. At its worst, that risked loans being presented as green or sustainability linked, when in reality they were little different to an ordinary loan, sometimes referred to as “green washing”.

Market standards for green loans were published by recognised industry associations in March 2018, and were followed in March 2019 by sustainability linked loan standards. Green and sustainability linked loans are now recognised products globally.

The drivers for the growth in green and sustainability linked loans are changing. What started as a mostly voluntary approach to addressing climate change risks and the need for businesses to act responsibly is beginning to be overtaken by regulation.

In a speech in 2015, the Governor of the Bank of England, Mark Carney, set out how the catastrophic impacts of climate change will be felt beyond the traditional horizons of most banks, investors and financial policy makers, imposing costs on future generations. He warned that once climate change becomes a defining issue for financial stability it may be too late, and noted that risks to financial stability will be minimised if the transition towards a lower-carbon economy begins early and follows a predictable path.

Considerable progress has been made in the years since that speech. In March 2019, Mark Carney spoke of a step change in demand and supply of climate reporting, the push to better climate change risk management and how advances in reporting and risk analysis are paving the way for investors to realise the opportunities in climate-friendly investment.

A raft of national and international initiatives on climate change and corporate governance are starting to change how companies operate. There seems little doubt that in the face of ever increasing pressure, the growth of the green and sustainability linked loan markets is set to continue.

Green loans and sustainability linked loans are two different products, but the term “green loan” is sometimes used as an umbrella term to cover both. The defining feature of a true green loan is that the proceeds are used for green purposes. Classification of a sustainability linked loan does not depend on how the proceeds are used – the key feature is that pricing is tied to the borrower’s performance against certain pre-determined sustainability criteria.
Development of green and sustainability linked loans

Green washing

One of the hurdles faced by the green and sustainable finance market generally is the potential for green washing. In October 2018, the UK’s Financial Conduct Authority (the “FCA”) issued a discussion paper on “Climate Change and Green Finance”, which noted that:

“Minimum standards can be helpful for enhancing investor confidence and trust and enabling markets to develop. For example, minimum standards may help ensure investors understand what they are buying and prevent misleading ‘green washing’ of financial products and services. Green washing is marketing that portrays an organisation’s products, activities or policies as producing positive environmental outcomes when this is not the case.”

Minimum standards have been developed for the loan markets. The Loan Market Association (“LMA”), Asia Pacific Loan Market Association (“APLMA”) and the Loan Syndications and Trading Association (“LSTA”) launched their Green Loan Principles with the support of the International Capital Market Association (“ICMA”) in March 2018. The Green Loan Principles are similar in scope to ICMA’s own Green Bond Principles. The initiative began in 2017 at the instigation of the Global Green Finance Council, of which the LMA and ICMA are founder members, and the APLMA, which established a working group in 2016.

A year later, in March 2019, the Sustainability Linked Loan Principles were published by the LMA, APLMA and the LSTA.

Both the Green Loan Principles and the Sustainability Linked Loan Principles are voluntary frameworks, widespread adoption of which would mitigate the risks of green washing in the loan markets.

The Green Loan Principles

The Green Loan Principles establish four key criteria:
> use of proceeds;
> the process of green project selection;
> management of proceeds; and
> reporting.

Use of proceeds

The fundamental defining feature of a green loan is that the proceeds are applied for green purposes. The Green Loan Principles include a non-exhaustive list of green projects towards which the proceeds of the loan could be applied, and require that the relevant green project provides clear environmental benefits.

Process of green project selection

Green borrowers are expected to communicate certain key information to their lenders including details of their wider environmental sustainability objectives, the process by which they determine whether their projects are eligible green initiatives and the related eligibility criteria. They are also expected to provide details of any wider green standards to which they seek to conform.

Management of proceeds

The Green Loan Principles provide that the proceeds of a green loan should be credited to a dedicated account, or otherwise tracked by the borrower in an appropriate manner. This requirement is aimed at ensuring transparent use of proceeds for eligible green purposes in order to promote the credibility of green loans. By holding green loan proceeds separately, borrowers can more easily ensure that they are applied towards the purposes for which they are drawn, particularly where the facility may be used for more than one purpose.

This also reduces the risk that proceeds are applied for other purposes and are not available to fund the relevant green project. Where the loan proceeds are to be applied over a period of time, borrowers are likely to prefer a staggered drawdown profile to drawing the whole amount of the loan to hold in a deposit account pending application (since the interest received on that deposit is likely to be less than the interest accruing on the drawn loan).

It is acknowledged in the Green Loan Principles that tracing the use of loan proceeds can be easier with a term loan than a revolving facility because revolving facilities tend to be flexible in the purposes for which they may be drawn. This can be addressed by structuring the facilities into separate tranches to make tracing easier – there are examples of revolving facilities split into tranches for general corporate purposes and for green purposes, for instance.

Reporting

The borrower of a green loan is required to record the green projects towards which proceeds are applied, together with a description of the project, the amount allocated and the expected impact of the project. Borrowers should renew that information annually and report it to their lenders.

The Green Loan Principles recommend (but do not require) third party oversight, and acknowledge that borrowers can seek guidance and input on their green loan processes in a variety of ways – examples include taking advice from external environmental consultants on their activities and arranging certification against external green assessment standards.
The Sustainability Linked Loan Principles

The key distinction between a green loan and a sustainability linked loan is that categorisation as a sustainability linked loan is not conditional on the proceeds being used for a particular purpose. Instead, the defining feature is that the terms of the loan incentivise the borrower to improve its performance against certain pre-determined environmental, social and governance (“ESG”) criteria. In practice this would typically mean that the pricing on the loan is directly linked to the sustainability performance of the borrower.

### Summary of the key features of the Green Loan Principles and the Sustainability Linked Loan Principles

<table>
<thead>
<tr>
<th></th>
<th>Green loans</th>
<th>Sustainability linked loans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aim</strong></td>
<td>&gt; To facilitate and support environmentally sustainable economic activity.</td>
<td>&gt; To facilitate and support environmentally and socially sustainable economic activity.</td>
</tr>
<tr>
<td><strong>Definition</strong></td>
<td>&gt; Loan instruments made available exclusively to finance or refinance new or existing “green projects”.</td>
<td>&gt; Loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower’s achievement of ambitious, predetermined sustainability performance objectives.</td>
</tr>
<tr>
<td><strong>Restrictions on purpose</strong></td>
<td>&gt; The fundamental feature is the utilisation of the loan for “green projects”. The Green Loan Principles set out a non-exhaustive list of 10 categories of green projects, including renewable energy, energy efficiency and pollution prevention and control. Loan proceeds should be credited to a dedicated account or otherwise tracked.</td>
<td>&gt; No specific requirement for use of proceeds – loan could be for a borrower’s general corporate purposes.</td>
</tr>
</tbody>
</table>
| **Impact on pricing of borrower performance** | > No pricing impact is contemplated in the Green Loan Principles.  
> There are facilities which have been split into tranches for green purposes and for other purposes where the green tranche attracts lower pricing. | > The hallmark of a sustainability linked loan is that the borrower’s performance against predetermined sustainability objectives affects the interest rate, incentivising improved performance over time.  
> The Sustainability Linked Loan Principles set out a non-exhaustive list of 10 common categories of objectives, including reduced greenhouse gas emissions, reduced water consumption and the amount of renewable energy generated or used by the borrower. |
| **Review/reporting**           | > Borrowers should maintain records of the use of green loan proceeds, including a list of the green projects to which the proceeds have been allocated together with a description of the project, amount allocated and the expected impact. External review is recommended but not required. | > The need for external review of the borrower’s performance against its predetermined sustainability objectives is decided on a case by case basis. For public companies, public disclosures may be sufficient to verify performance for the purposes of the loan. |
The rise of green loans and sustainability linked lending
Market activity

According to Bloomberg data, global green and sustainability linked loan volumes exceeded US$99bn in 2018, with sustainability linked loans accounting for US$43.2bn of that (see Figure 1). Global sustainability linked loan activity in particular is clearly on the rise, and the rate of growth is increasing year on year. Projected sustainability linked loan volumes for 2019 exceed US$81bn based on extrapolating from deals announced between 1 January 2019 and 12 June 2019 (see Figure 2).


**Figure 1: Aggregate volumes of announced green and sustainability linked loans, 2014 – 2019 YTD (US$bn)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Green loans</th>
<th>Sustainability linked loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>15.8</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>28.7</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>38.1</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>45.6</td>
<td>10.6</td>
</tr>
<tr>
<td>2018</td>
<td>55.9</td>
<td>43.2</td>
</tr>
<tr>
<td>2019 YTD</td>
<td>36.1</td>
<td>14.8</td>
</tr>
</tbody>
</table>


**Figure 2: Aggregate volumes of announced sustainability linked loans 2017 – 2019 (extrapolated from YTD data) (US$bn)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Announced aggregate loan value</th>
<th>Extrapolated volumes for the rest of the year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>10.6</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>43.2</td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td></td>
<td>36.1</td>
</tr>
</tbody>
</table>

The rise of green loans and sustainability linked lending

A look at aggregate volumes of sustainability linked loans by jurisdiction over recent years shows that European jurisdictions are particularly active (see Figure 3), but the product reaches into markets globally.

Sustainability linked loan activity is spread across various sectors, but has been dominated by borrowers in the utilities, financials and consumer sectors (see Figure 4).

**Figure 3: Aggregate volumes of announced sustainability linked loans by jurisdiction, 2017 – 2019 YTD (US$bn)**

- Spain: 19.3
- France: 19.3
- Italy: 12.5
- United States: 11.6
- Netherlands: 9.2
- United Kingdom: 4.9
- Belgium: 3.4
- Germany: 1.7
- Finland: 1.2
- Singapore: 1.2
- Others: 5.6


**Figure 4: Aggregate volumes of announced sustainability linked loans by borrower industry, 2017 – 2019 YTD**

- 41% Utilities
- 19% Financials
- 14% Consumer
- 9% Industrials
- 6% Materials
- 11% Others


Europe

European markets currently lead global sustainability linked loan volumes, with a share of more than 80% of the market (see Figure 5). Activity has focused mostly on Spain, France and Italy.

The Americas

While only a handful of sustainability linked loans have been made to US companies, aggregate volumes of announced deals to date total approximately US$11bn according to Bloomberg. Many of the larger transactions have been for subsidiaries of European companies that have entered into sustainability linked loans in their own right already.

Asia-Pacific

Green and sustainability linked lending is also attracting considerable attention in the Asia Pacific markets. The first sustainability linked loan in the region was reported to have been signed in March 2018, and the first green loan dates back to September 2018, both for Singaporean companies. Sustainability linked loans have also been signed in Hong Kong. Singapore features in the top 10 countries by aggregate sustainability linked loan volumes since 2017.

Figure 5: Aggregate volumes of announced sustainability linked loans by borrower region, 2017 – 2019 YTD


European jurisdictions are particularly active in sustainability linked loans, but the product reaches into markets globally.
The rise of green loans and sustainability linked lending
Trends in green and sustainability linked loans

Green loans

The Equator Principles were first published in 2003 and incorporate the International Finance Corporation Performance Standards and the World Bank Group’s technical industry guidelines for projects in emerging markets. The Equator Principles are intended to help ensure that project finance transactions are undertaken in a socially responsible way and in accordance with appropriate environmental management practices.

While widely adopted in the project finance sector, the Equator Principles are rarely encountered in ordinary corporate loan transactions. The introduction of the Green Loan Principles may have broader reach into other parts of the loan markets, but they are less established than the Equator Principles.

While the Green Loan Principles do not contemplate the pricing on the loan being linked to green use of proceeds, that linkage has been a feature of some corporate financings. In one example, a revolving credit facility for general corporate purposes was split into two tranches – the first tranche, which was available for general corporate purposes, did not benefit from any discount, but the second tranche, which was available only for green purposes had reduced pricing.

One-way or two-way pricing

Early financings were structured such that if the borrower satisfied its sustainability criteria, the margin on the loan was reduced. The size of that reduction varied between loans and markets, but might typically be in the range of 0.02% to 0.04% on a general corporate financing. In some markets the discount might be higher – as much as 0.10% to 0.20%.

Where sustainability targets were not met, the margin calculation mechanism on those financings had no penalty for poor performance. Instead the margin reduction was simply not applied.

More recently, two-way pricing mechanisms have been introduced on some deals. Two-way pricing mechanisms better incentivise performance by providing for a pricing reduction if sustainability criteria are met, and applying a pricing increase where performance declines.

The underlying objective of incentivising borrowers to make improvements to their sustainability profile is probably more likely to be achieved through two-way pricing mechanisms, but it is possible that they could be viewed in a less positive way – after all, they result in lenders making greater returns on loans from borrowers who are not meeting sustainability targets.

There are examples of alternative structures being considered, which could mitigate that concern. One idea replaces increases in pricing with a requirement to make additional payments into a separate bank account should sustainability targets not be met. Those amounts could then be reinvested into improving the sustainability profile of the borrower.

"Two-way pricing mechanisms better incentivise performance by providing for a pricing reduction if sustainability criteria are met, and applying a pricing increase where performance declines."
The rise of green loans and sustainability linked lending

Third party oversight

The Sustainability Linked Loan Principles state that the need for external review of the borrower’s ESG performance is to be negotiated and agreed on a transaction by transaction basis. Where information relating to sustainability performance targets is not publicly available or otherwise accompanied by an audit or assurance statement, the Sustainability Linked Loan Principles recommend that external review of those targets is sought. Even where data is publicly disclosed, independent external review may be desirable. The majority of deals signed to date require external review rather than relying on self-reporting. This is in some ways similar to the requirement for an independent environmental and social consultant under the Equator Principles.

A number of factors influence whether third party oversight is required by lenders. At a general level, the integrity of the product is promoted by credible independent review. In many cases, self-reporting is not feasible because borrowers do not have the internal expertise to perform the role themselves. Larger corporates, which may have the necessary internal expertise to self-report, are encouraged by the Sustainability Linked Loan Principles to thoroughly document that expertise and their internal processes.

One reason borrowers might prefer to self-report is to avoid incurring an increased cost burden. It is worth bearing in mind the wider trend toward companies assessing and reporting on their ESG performance for other purposes, so to the extent information is already being gathered, it may be possible to repurpose it for a lower incremental cost.

Methodology changes

A less obvious concern is the potential for external ESG rating providers to change their methodologies unilaterally. There are many entities in the market that research and rate corporate sustainability, although reporting in the loans market is concentrated on a smaller group of providers.

Each of the ESG rating agencies consider various data points to arrive at their respective ratings. Their rating methodologies are not only varied from each other, but evolve over time. In part that reflects shifts in perception towards particular risk factors – what is considered green or sustainable today may be less so tomorrow. For example, the production of electric vehicles might in some cases rely on the transport and use of raw materials that are extracted using polluting methods or perhaps involving poor employment conditions. Early ESG ratings tended not to differentiate between sectors when assessing the relevance of particular risks, but as the market becomes more sophisticated, rating methodologies are becoming more tailored.

Evolving rating methodologies can also be the result of consolidation in the market. For example, Sustainalytics acquired ESG Analytics in 2015. Vigeo Eiris, was formed in 2015 by the merger of Vigeo and Eiris, both of which were ESG data providers. There are also moves from credit rating agencies into the market – Moody’s acquired a majority stake in Vigeo Eiris in April 2019.

As the market becomes more sophisticated, rating methodologies are becoming more tailored.
Concerns have been raised about the low correlation between different ESG rating agencies’ assessment of the same company, which contrasts with the strong positive correlation generally seen in the context of credit ratings. This is a challenge for investors seeking a comparative assessment across companies with ratings provided by different sources. It is perhaps less of a problem in the loan markets where a particular ESG rating agency’s rating is being used to demonstrate an improvement in the performance of the borrower over time rather than to compare different borrowers. In time, the industry may well develop a more uniform approach, but to get there will require greater standardisation of the various methodologies used currently.

Changing methodologies could create a potential difficulty for the sustainability linked loans market. It is agreed when the loan is entered into that the pricing will change by reference to whether particular ESG performance targets are hit. If a rating agency changes its calculation methodology for whatever reason during the life of the loan, and that results in changes to a particular corporate’s rating, the pricing on the loan may also change. Whether or not methodology changes are significant enough to have a substantial impact is another question.

It is not uncommon for the facility agreement to include a list of possible rating providers or otherwise contemplate that the rating provider could change over the life of the loan.

Sustainability criteria

The suggested criteria listed in the Sustainability Linked Loan Principles are indicative only – the critical factor is that the criteria chosen are ambitious and meaningful to the borrower’s business.

Market participants are not tied to using only the criteria listed in the Sustainability Linked Loan Principles. Metrics such as target CO₂ emissions are common, but there are examples of novel criteria relevant to the borrower’s business, such as the proportion of electric vehicles in an electricity company’s fleet, or improvements in uptake of energy consumption monitoring tools among customers of a utility company. Criteria can be tailored to the business – for instance, the three-year average intensity of CO₂ emissions in kilograms per megawatt hour of power produced by an electricity company.

It is common for pricing to be set by reference to the borrower’s overall ESG rating (which is typically expressed on a scale of 0 to 100, although some ESG rating agencies use a scale similar to that of the credit rating agencies). The borrower’s ESG rating is usually assessed annually, and a discount (or increase) to the applicable margin is applied if the ESG rating has moved more than a few points higher or lower than the initial ESG rating at the time the loan was entered into. The threshold for a change to the ESG rating to impact the applicable margin varies, but tends to be in the range of two to five points (on a scale of 0 to 100). The annual changes to the margin are not usually cumulative – the discount (or increase) is applied each year to the originally applicable margin if the ESG rating has moved sufficiently from the initial ESG rating, rather than to an already discounted (or increased) figure.

On transactions where specific ESG criteria are used rather than an overall rating, different discounts (or increases) can be applied for each specific target that is met. The alternative is an all or nothing approach that requires all targets to be met before the pricing changes.

It is common for pricing to be set by reference to the borrower’s overall ESG rating, typically expressed on a scale of 0 to 100.
What is driving the rise of green and sustainability linked finance?

There is no single driver for the rise of green and sustainability linked finance. Instead, a raft of national and supranational initiatives are part of a wholesale shift to embed climate change risk and ESG risks at the heart of business strategy.

The Equator Principles
Adoption of the Equator Principles referred to earlier in this report is voluntary, but many financial institutions use the Equator Principles as a primary tool for managing ESG risks and impacts in the project finance market. The Equator Principles paved the way for other sustainability initiatives in the loan markets.

UNPRI
The UN Principles for Responsible Investment (“UNPRI”) are a longstanding voluntary initiative to incorporate ESG issues into investment practice. The UNPRI focus on, amongst other things, the incorporation of ESG issues into investment analysis and ownership policies and the disclosure of ESG issues.

Recommendations of the Task Force on Climate-related Financial Disclosures and Principles for Responsible Investment
The shift to embed climate and ESG risk factors into corporate decision making gained further traction following the Paris Agreement in 2015. In December 2015, the Financial Stability Board announced the establishment of an industry-led Task Force on Climate-related Financial Disclosures, with the goal of developing voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to lenders, insurers, investors and other stakeholders. In June 2017, the Task Force published its recommendations (the “TCFD Recommendations”), which give guidance on how to disclose clear, comparable and consistent information about the risks and opportunities presented by climate change. The core elements of the TCFD Recommendations concern governance, strategy (including scenario analysis), risk management and metrics and targets, each in relation to climate risk.

The impact of the TCFD Recommendations is significant, with financial institutions increasingly taking note of the TCFD Recommendations in their sustainability disclosures. There is potential for compliance with the TCFD Recommendations to become mandatory (on a comply or explain basis) in the near to medium term.

The general trend towards embedding climate- and ESG-related issues in business strategy, and on increased disclosure, is clear.
The rise of green loans and sustainability linked lending

European initiatives

As part of its programme to fulfil commitments made pursuant to the Paris Agreement, the European Commission adopted a sustainable finance action plan. The European Commission unveiled its strategy for a financial system that supports the EU’s climate and sustainable development agenda in 2018. The action plan on sustainable finance has three main objectives:

- to reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth;
- to manage the financial risks stemming from climate change, environmental degradation and social issues; and
- to foster transparency and long-termism in financial and economic activity.

The remaining part of the EU Sustainable Finance Package is a new taxonomy regulation, together with a detailed draft taxonomy issued pursuant to it, that defines what activities are eligible to be the subject of sustainable finance. The draft technical taxonomy published in June 2019 is intended to be finalised by the end of 2019. Once in final form and in force (which will not be before 2021), it will require the application of a series of tests to determine whether activities qualify as climate mitigation focussed activities or climate adaptation focussed activities, each eligible for sustainable finance.

In order for an activity to qualify as climate mitigation focussed, this involves:

- the identification of economic activities that could be eligible under the taxonomy. Over 60 categories of activity are contemplated, but activities in some sectors, such as coal mining, are not currently eligible;
- for each potentially eligible activity, verification of whether it meets certain screening criteria as to emission performance (for example, for power generation there is a maximum limit on CO₂ emission per kilowatt hour that must be satisfied);
- assessment of whether the activity also passes the test of doing no significant harm to the environment;
- due diligence to verify that the activity satisfies minimum social safeguard requirements, in particular, the International Labour Organisation’s core labour conventions; and
- the alignment of investments with the taxonomy requirements and preparation of disclosures at the investment product level.

In order for an activity to be considered climate adaptation focussed, the first two tests outlined above are replaced by:

- an assessment of the expected adverse physical effects of climate change on the underlying economic activity or assets, and
- demonstration of how the activity will substantially reduce or prevent (or prevent the increase of) those adverse physical effects.

While the taxonomy will not be applicable to bank lending as a matter of EU regulation, it is possible that over time the market may choose to apply it voluntarily, for example in response to customer or other regulatory expectations.

The European Banking Authority stated in its 2018 Annual Report that it is conducting market analysis and research on ESG factors and that sustainable finance will continue to be an important area in its work.

The European Non-Financial Reporting Directive (Directive (EU) 2014/95) (the “NFRD”) came into force in the UK from 1 January 2017. The NFRD requires large companies which are public interest entities (broadly, EU-listed companies, certain credit institutions and insurance undertakings) to report publicly on environmental, social and employment matters, respect for human rights and anti-corruption and bribery matters. In non-binding guidance in relation to the NFRD, the European Commission cross-referred to the TCFD Recommendations, showing the convergence in climate change related disclosures.

Related developments in this area at an EU level are noted in the appendix to this report.
UK initiatives

UK regulators and legislators are taking action too. The Prudential Regulation Authority (the “PRA”) published Policy Statement 11/19 and Supervisory Statement 3/19 on “Enhancing banks’ and insurers’ approaches to managing the financial risks from climate change” in April 2019. The Supervisory Statement sets out the PRA’s key expectations on how UK banks and insurance firms should address those risks at a strategic level. In it, the PRA makes clear that firms should:

> fully embed consideration of climate change risks in their governance arrangements;
> take those risks into account in existing risk management practices;
> where appropriate, use scenario analysis to assess the impact of climate change risks on their strategy and risk profile; and
> develop an appropriate approach to disclosure of climate-related financial risks.

Separately, the FCA is also considering climate change and green finance, including the adequacy of current disclosures in capital markets.

From October 2019, pension funds will be required to ensure that their statement of investment principles addresses any financially material considerations. This is defined specifically to include ESG factors, including climate change.

Related developments in this area in the UK are noted in the appendix to this report.

Other pressures

Climate- and ESG-related investor engagement is increasing. Shareholder activism is too. The International Organization of Securities Commissions, the internationally recognised global standard setter for the securities sector, has issued a statement on the importance of ESG-related matters when disclosing information material to investor decisions. Separately, at least one shareholder advisory body has updated its guidelines to make clear that it expects companies to publish information on their resilience to climate change as part of their wider environmental policy. Particular sectors have tended to concentrate on different ESG matters – climate change has been key in the energy sector, whilst social issues are more commonly encountered in the mining sector for example.

The general trend towards embedding climate- and ESG-related issues in business strategy, and on increased disclosure, is clear. It seems reasonable to expect that as the number of companies assessing and reporting on these matters grows, so will the number of companies able to re-use that same data for the purposes of green or sustainability linked loans.
The rise of green loans and sustainability linked lending
Although changes to the regulatory capital treatment of green and sustainability linked loans are in contemplation at both a European and UK level, they are in their infancy. The main focus of regulators appears to be on driving a conscious governance and disclosure framework and on integrating ESG risks into regulated firms’ risk management policies.

The EU position

CRR

The legislative package establishing the framework of regulatory capital, liquidity, leverage and regulatory disclosure rules applicable to European credit institutions and investment firms is set out in Regulation (EU) 575/2013 (the Capital Requirements Regulation or “CRR”) and Directive (EU) 2013/36 (the Capital Requirements Directive or “CRD”).

Under the current rules, institutions using the standardised approach to assess their borrower’s credit risk do not take ESG factors into account.

CRR will be amended by Regulation (EU) 2019/876 (“CRR 2”). While CRR 2 will not make changes to the regulatory capital treatment of green and sustainability linked loans generally in the short term, it will offer limited preferential treatment for certain highly prescribed arrangements and require the development of governance and disclosure frameworks and the integration of ESG risks into regulated firms’ risk management policies. In particular:

> under CRR 2, the European Banking Authority is mandated to assess whether exposures related to assets or activities associated substantially with environmental and/or social objectives require a bespoke prudential treatment. The European Banking Authority must submit a report on its findings by mid-2025. CRR 2 contemplates that a legislative proposal may be produced on the basis of that report, if appropriate;

> CRR 2 provides for preferential treatment of exposures to corporates specifically set up to fund public infrastructure where the corporate has carried out an assessment of whether the assets being financed contribute to certain environmental and sustainability objectives and satisfy various other tests. Loans made to corporates which are not set up to fund public infrastructure would not benefit from preferential treatment; and

> CRR 2 also imposes various ESG risk disclosure requirements.

Regulation of investment firms

The proposed European prudential regulatory regime for investment firms (set out in a draft regulation known as the “IFR” and a draft directive known as the “IFD”) has a similar emphasis:

> the IFR mandates the European Banking Authority to assess whether exposures related to assets or activities associated substantially with environmental and/or social objectives require a bespoke prudential treatment and, if so, a legislative proposal will follow;

> the IFD mandates the European Banking Authority to prepare a report which will assess the possible sources and impact of ESG related risks on investment firms. The European Banking Authority may adopt relevant guidelines if appropriate;

> certain investment firms will be required to disclose ESG risks; and

> within 3 years of the introduction of the IFR and IFD (which means by 2024), the European Commission will submit a report and (if appropriate) a legislative proposal concerning the treatment of ESG risks in investment firms’ internal governance, remuneration policies and risk policies.
The UK position

The PRA’s climate change policy

Turning to the UK, the PRA and the FCA have established the Climate Financial Risk Forum ("CFRF"). The objective of the CFRF is to build capacity and share best practice across financial regulators and industry to advance financial sector responses to the financial risks from climate change. The work of the CFRF, combined with the PRA’s international work with the Central Banks and Supervisors Network for Greening the Financial System helps to inform the PRA’s approach to climate change policy.

PRA Policy Statement and Supervisory Statement

The PRA’s recently published Policy Statement 11/19 and Supervisory Statement 3/19 on “Enhancing banks’ and insurers’ approaches to managing the financial risks from climate change” referred to earlier in this report focus on the impact of climate change on the value of assets and on wider socioeconomic developments which could have an indirect impact on the risks faced by regulated firms. For these purposes, the PRA has broadly split climate change risks into physical risks (such as extreme weather events causing damage to physical assets) and transition risks arising from the process of adjustment to a low carbon economy.

In the Policy Statement, the PRA notes that respondents to an earlier consultation paper had urged it to reflect climate-related financial risks in the capital framework. However, the Policy Statement confirms that the PRA “does not consider that differences in capital treatment for certain types of assets is appropriate at this stage given the lack of a consistent definition of assets with less climate-related risk, and lack of data or other evidence of a risk differential between them.”

The PRA’s expectations at this stage are for firms to:

> embed the consideration of the financial risks from climate change in their governance arrangements;
> incorporate the financial risks from climate change into existing financial risk management practice;
> use long term scenario analysis to inform strategy setting and risk assessment and identification; and
> develop an approach to disclosure of the financial risks from climate change.

Notably, the PRA indicates that it expects such analysis to be reflected in the formal internal capital adequacy assessment framework (ICAAP) which banks use, and the insurers’ equivalent framework (ORSA), though with no specific guidance as yet on how to do so.

The Senior Managers and Certification Regime

The PRA expects firms to have clear roles and responsibilities for the board and its sub-committees in managing the financial risks from climate change – the board and the highest level of executive management should allocate responsibility for identifying and managing those risks to the most appropriate Senior Management Function.
We have extensive experience advising on green and sustainable loan transactions. We are also at the forefront of legal and regulatory developments on ESG across Europe, Asia and the US, as national and regional regulators drive changes to the banking landscape.

We offer our clients a global service, both in outlook and reach. Our network of 30 offices is reinforced by an integrated alliance with Allens, the leading Australian law firm with offices throughout Asia, our collaborative alliance with Webber Wentzel, South Africa’s premier full-service law firm, and our best friend relationship with Talwar, Thakore & Associates (TT&A), a leading Indian law firm. In regions where we or they do not have an office and may not practice local law, we have strong relationships across local firms.
The rise of green loans and sustainability linked lending
# Appendix

## Key EU initiatives on climate change and sustainability

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Summary</th>
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<tbody>
<tr>
<td><strong>The Sustainable Finance Package</strong></td>
<td>The EU Sustainable Finance Package includes three main initiatives:</td>
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<td>&gt; a regulation amending the European Benchmark Regulation to introduce new categories of regulated benchmarks to help investors compare the carbon footprint of their investments;</td>
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<td>&gt; a regulation on disclosure requirements which will require a broad range of regulated entities to disclose how they integrate ESG factors into their investment decision making and advisory processes, as well as make specific disclosures for certain ESG products; and</td>
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<td></td>
<td>&gt; an ESG taxonomy regulation which will create a framework to assess whether a particular economic activity can be considered environmentally sustainable, and will require application of, and disclosure against, criteria for sustainable investments.</td>
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<td><strong>ESMA guidelines on disclosure requirements applicable to credit ratings</strong></td>
<td>The European Securities and Markets Authority has been consulting on guidelines for credit agencies, which would improve how credit agencies disclose their consideration of ESG factors as part of the credit rating process.</td>
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<td><strong>ESMA and EIOPA technical advice to the European Commission</strong></td>
<td>The European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority have published technical advice to the European Commission on the integration of ESG risks into a number of pieces of European legislation, including Solvency II, the Insurance Distribution Directive, MiFID II, AIFMD and the UCITS Directive.</td>
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<td><strong>EIOPA opinion on sustainability within Solvency II</strong></td>
<td>The European Insurance and Occupational Pensions Authority is consulting on an opinion on sustainability within the current Solvency II framework which will inform the European Commission’s review.</td>
</tr>
<tr>
<td><strong>The Capital Requirements Regulation 2 and Capital Requirements Directive V Package, and the Investment Firms Regulation and Directive Package</strong></td>
<td>CRR 2/CRD V and IFR/IFD both require ESG disclosures as part of “Pillar 3” prudential regulatory requirements for investment firms and banks. Both packages empower the European Banking Authority to consider the enactment of a dedicated prudential treatment of ESG investments.</td>
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<td><strong>Shareholder Rights Directive II</strong></td>
<td>SRD II requires shareholder engagement disclosures by both institutional investors and asset managers. Whilst these disclosures are not directly focussed on ESG matters, the intention of encouraging active shareholder engagement and long-term stewardship overlaps with the sustainable finance agenda.</td>
</tr>
<tr>
<td>Initiative</td>
<td>Summary</td>
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| **European Commission guidelines on climate-related disclosures** | The European Commission adopted guidelines on reporting climate-related information in June 2019. These supplement existing guidelines on non-financial reporting under EU Directive 2013/34 on the disclosure of non-financial and diversity information by certain large undertakings and groups.  
The guidelines build on the report published by the EU Technical Expert Group on Sustainable Finance ("TEG") in January 2019 on climate-related disclosures, which recommends a wide range of disclosures in relation to climate-related risks and opportunities. |
| **TEG report on EU taxonomy**                  | This TEG report lists economic activities which can make a substantial contribution to climate change mitigation and climate change adaptation. The report is part of the workstream on the proposed EU Taxonomy Regulation.                                                   |
| **TEG report on an EU Green Bond Standard**    | This report proposes a voluntary green bond standard to determine climate and environmentally-friendly activities eligible for funding under green bonds.                                                                 |
| **TEG interim report on EU climate benchmarks and disclosure by benchmark providers** | This interim report proposes the methodology and minimum technical requirements for climate benchmarks and disclosure requirements for benchmark providers. |

### Key UK initiatives on climate change and sustainability

<table>
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<tr>
<th>Initiative</th>
<th>Summary</th>
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| PRA supervisory statement for banks and insurers on managing the financial risks from climate change | On 15 April 2019, the PRA released a Policy Statement and a Supervisory Statement applicable to all UK banks and insurance firms. These set out the PRA’s expectations on managing the financial risks from climate change. The PRA expects that firms should:  
  > fully embed consideration of climate change risks in their governance arrangements;  
  > take those risks into account in existing risk management practices;  
  > where appropriate, use scenario analysis to assess the impact of climate change risks on their strategy and risk profile; and  
  > develop an appropriate approach to disclosure of climate-related financial risks.  
  Firms should have an initial plan to address the PRA’s expectations by 15 October 2019, and the PRA will publish more information in due course. |
| FCA consultation on climate change and green finance | The FCA issued a discussion paper on climate change and green finance in October 2018, seeking views on the FCA’s proposed approach to the area to ensure the FCA “continues to take decisions in the public interest and supports innovation in the growing market for green finance”. |
| Reporting requirements for large companies | The Companies (Miscellaneous Reporting) Regulations 2018 changed company reporting requirements in relation to financial years beginning on or after 1 January 2019. Large companies are required to include a statement in their strategic report explaining how directors have met their duties under section 172 of the Companies Act 2006 to promote the success of the company. Section 172 requires directors to have regard, amongst other matters, to the impact of the company’s operations on the community and the environment. |
| FRC guidelines on board effectiveness | The Financial Reporting Council regulates auditors, accountants and actuaries in the UK. It also sets the UK’s corporate governance and stewardship codes. Its Guidance on Board Effectiveness notes that boards may wish to use a voluntary framework to help identify the ESG factors that are relevant for their business and link them to company strategy. |
| Proposed FRC revisions to UK Stewardship Code | The Financial Reporting Council has consulted on revisions to the UK Stewardship Code due in Summer 2019. Compliance with the Stewardship Code is voluntary, but on a “comply or explain” basis for UK regulated firms. The proposed amendments include a requirement to take ESG factors into account when fulfilling stewardship responsibilities. |
| Requirements for pension trustee statements of investment principles | New regulations come into force in October 2019 requiring pension trustees to document how they have considered ESG factors and their policy towards stewardship in their statements of investment principles. |
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